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1st Session

SENATE

REPORT
100-191

SECOND MONETARY POLICY REPORT FOR 1987

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

A REPORT

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

OCTOBER 6 (legislative day, SEPTEMBER 25), 1987.—Ordered to be printed

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, October 6, 1987.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the Second Monetary Policy Report for 1987 on the Conduct of Monetary Policy, pursuant to Public Law 95-523 and oversight hearing held on July 23, 1987.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

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OCTOBER 6 (legislative day, SEPTEMBER 25), 1987.—Ordered to be printed

Mr. PROXMIRE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

[Submitted pursuant to Public Law 95-523]

INTRODUCTION

On July 23, 1987, the Committee on Banking, Housing, and Urban Affairs held a monetary policy hearing as called for by the Full Employment and Balanced Growth Act of 1978. At this hearing, the Committee received from the Federal Reserve the "Monetary Policy Report to Congress" and heard the testimony of its chairman, Paul A. Volcker, on the conduct of monetary policy during the first half of 1987 and the Federal Reserve's monetary policy objectives for the remainder of 1987 and for 1988.

The testimony of the Federal Reserve Chairman and information available at the time of the hearing provided the Committee with an ample body of information on which to base the Committee's findings and recommendations. Like the last monetary policy report, the Committee's findings and recommendations in this report touch on international economic interdependence and cooperation. This is the natural consequence of the strong relationships known to exist among the U.S. fiscal and trade deficits, the rates of exchange between the dollar and other industrialized-nation currencies, and the dependency of U.S. interest rates on the degree of monetary and fiscal tightness in the other industrialized nations.

The Committee's findings and recommendations are herewith transmitted to the Senate for its consideration and use.

FINDINGS AND RECOMMENDATIONS

1. On the occasion of the resignation of Paul A. Volcker from the Chairmanship of the Federal Reserve Board of Governors, the Committee finds that under Mr. Volcker's leadership, the Federal Reserve has been a potent and effective force in the reduction of infla-

tion in the United States, the continuance of the current economic expansion, and the maintenance of financial soundness in U.S. financial institutions. Mr. Volcker has also been a tireless, consistent, and articulate advocate of Federal deficit reduction and amelioration of the trade deficit through increases in domestic savings. For these efforts, his many successes, and years of dedicated public service, the Committee expresses its most profound appreciation.

2. The Committee finds the Federal Reserve's intended monetary policy actions for the remainder of 1987 and for 1988 as reported to the Committee to be acceptable in the context of current domestic and international economic conditions.

RANGES OF GROWTH FOR MONETARY AND DEBT AGGREGATES

[Percent change, 4th quarter to 4th quarter]

	1987	1988
M2	5½ to 8½	5 to 8.
M3	5½ to 8½	5 to 8.
Debt	8 to 11	7½ to 10½

The target ranges for 1987 are unchanged from earlier in 1987. The target ranges for 1988 represent reductions from the ranges presented in the Federal Reserve's first monetary policy report. The target ranges for M2 and M3 are reduced from 6 to 9 percent and that for debt from 8 to 11 percent. This shift is appropriate, in the Committee's judgment, in view of the continued strength of the U.S. economy, the potential for increased inflation, the enormous U.S. budget deficit, and the need to continue to attract funds from overseas.

3. The Committee finds that great care should be taken to assure that the potential for inflation implicit in the decline in the foreign exchange value of the dollar is not realized as a result of misinterpretation and policy overreaction.

The decline in the value of the dollar relative to the currencies of other industrialized nations is resulting in an adjustment of relative prices in the United States, making foreign goods more expensive and exerting a beneficial downward pressure on the U.S. trade deficit. If, however, management and employee groups seek and obtain compensation increases to preserve their purchasing power in the face of rising import prices, domestic prices will tend also to rise, minimizing any shift in the relative prices of imported and domestically produced goods. In turn, real exchange rate change and its beneficial impact on the trade deficit will be minimized, and downward pressure on the nominal exchange rate would likely increase, resulting in higher compensation demands and even higher domestic prices. A serious wage-price spiral could ensue to which the Federal Reserve would have to respond by accommodating it with an increasingly expansive monetary policy or terminating it with a monetary contraction containing significant recessionary risks. In the Committee's judgment, great care should be taken by both private and governmental policymakers to guard against do-

mestic compensation and pricing actions that minimize the effects of real exchange rate shifts.[1]

4. The Committee finds, as it did in its first monetary policy report for 1987, that there is a need to shift U.S. economic priorities away from consumption and into investment in order to reverse the present trade imbalance and ensure long-term economic stability.

The economic challenge faced by the United States is a complex one consisting of at least four interrelated problems. Senator Shelby made note of each of them—the budget deficit, the trade deficit, the national debt, and the low U.S. savings rate—in his questioning of Federal Reserve Chairman Volcker. Chairman Volcker commented:

> They really are all part of the same problem. They are all reflecting the fact that we are spending more at home and consuming more at home than we are really producing and can afford, and that is reflected in over-borrowing by the Government and it's reflected by over-borrowing by private entities, and both of those are reflected by the low savings rate and reflected in the borrowing from abroad.

If the United States is to reduce its dependence on imported goods and reverse its trade balance, the relationship between domestic spending and output must be reversed. The Committee is aware that a reduction in the growth of consumption spending will affect virtually every sector of the U.S. economy. And to the extent living standards are measured in consumption terms, there must necessarily be a reduction in the rate of improvement, at least in the medium term. Over the longer term, however, the present mix of U.S. spending and investment cannot be sustained; our future living standards will be higher only if we shift toward more investment.

Achieving a meaningful shift in U.S. resource allocation from consumption to investment will involve overcoming enormous economic policy challenges. Success will require the best efforts of U.S. policymakers and unprecedented cooperation and economic coordination among the industrialized nations.

5. The Committee finds that the present degree of monetary and fiscal policy coordination between the United States and its two key trading partners, Japan and West Germany, is still insufficient to assure economic stability and growth internationally.

The major industrialized nations abroad, principally Japan and West Germany, have depended on strong net export growth rather than domestic demand expansion to buoy their economies in recent years. The contractionary adjustments needed in U.S. macroeconomic policies must be accompanied by expansionary adjustments in the monetary and fiscal policies of our major trading partners if worldwide growth is to be sustained. The Japanese Government is in the initial stages of implementing a major fiscal expansion pack-

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[1] For a fuller discussion of inflationary potential see, "The Threat of Inflation," Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, Committee Print 100-3, U.S. Government Printing Office, Washington, DC, July, 1987.

age and should be complimented for its efforts to date. West Germany has been much slower to respond. The Committee urges the Federal Reserve and the Administration to continue to use every appropriate means to encourage our major trading partners to adopt and maintain more expansive monetary policies and, particularly, more stimulative fiscal policies.

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